March 1, 2004

Mary L. Cottrell, Secretary
Department of Telecommunications and Energy
One South Station, 2nd Floor
Boston, Massachusetts 02110

Sent by e-mail, telefax and first class mail

RE: *Assignment of Interstate Pipeline Capacity*, D.T.E. 04-1

Dear Secretary Cottrell:

On January 12, 2004, the Department opened an investigation to determine whether the interstate pipeline capacity and other upstream natural gas markets are sufficiently competitive to allow local gas distribution companies ("LDCs") to assign capacity rights voluntarily, rather than on the current mandatory basis. *Assignment of Interstate Pipeline Capacity*, D.T.E. 04-1 at 1. The Department specified five areas to be addressed:

1. The number of transportation customers;
2. The number of marketers;
3. The percentage of the market that has converted to transportation service (both in volume and number of customers);
4. Developments at the FERC regarding this matter; and
5. Mechanisms by which the LDCs can include other affected market participants in an LDC's capacity planning process.

The Department did not limit comments to these areas.

**Summary**

The Department should expand its investigation into the competitiveness of gas markets to incorporate broader, but related, issues. These broader issues include: (1) how LDCs plan and procure supplies and capacity, and (2) how to bring choice to customers who have none. The Department should resolve these important issues during the transition period in order to deliver on the promises made when it initiated unbundling. The Attorney General looks forward to working with the Department, the LDCs and other interested parties to address the development of the competitive retail natural gas market in Massachusetts.

## Background

In 1997 the Department ordered the Massachusetts investor owned LDCs to develop comprehensive principles for the unbundling of services in preparation for the opening of the natural gas supply market to competition. The Department directed the LDCs to initiate an industry wide collaborative. The Massachusetts Gas Unbundling Collaborative's ("MGUC")[1] developed model terms and conditions for suppliers and distribution companies, protocols for customer enrollment and data exchange, and guidelines for unbundling LDC rates into delivery service and gas supply components. LDC Report on Status of Gas Unbundling, December 24, 1998. The Collaborative was unable to resolve key issues regarding (1) the assignment of LDC rights to interstate pipeline and storage capacities, and (2) the structure of default service. LDCs and customers favored mandatory capacity assignment. Marketers preferred voluntary assignment, claiming that they generally had their own resource portfolios to serve customers and the assigned capacity would be redundant.

The Department described its vision of a fully competitive gas industry as an environment where all customers have a choice among a wide range of providers and LDCs are responsible for only the distribution of gas. *Natural Gas Unbundling,* D.T.E. 98-32-B at 35 (1999). The Department adopted mandatory capacity assignment, finding that it was necessary to avoid cost shifting from migrating customers to those customers continuing to receive their gas supply service from the LDC. *Id.* at 35. The Department agreed with the LDCs that they should auction their resource portfolios to wholesale marketers who were in a better position to optimize the assets and bring value to both customers and the competitive marketplace[2]. The Department determined that mandatory capacity assignment, when coupled with a portfolio auction, was "...suited to provide all Massachusetts gas customers with reliable, safe and least-cost service." *Id.* at 54. The Department noted "...that the conditions precedent to a fully competitive market structure for interstate pipeline and storage capacity have not yet been fulfilled. Because the upstream capacity market currently is not sufficiently competitive, the LDCs' obligation to serve cannot now be eliminated if the reliability of the system is to be maintained." *Id.* at 58. The Department established a transition period of up to five years to resolve issues of capacity assignment and cost responsibility, and stated that it intended to review the level of upstream competition at the end of the first three years of the transition period to determine whether the

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[1] The MGUC included government agencies, the Massachusetts LDCs, consumer advocates, gas marketing firms, and other interested parties.

[2] The portfolio auction, as presented by the LDCs, involved soliciting bids for their upstream capacity resources (interstate pipeline transportation and natural gas storage rights) from wholesale marketers. The Department anticipated that the wholesale marketers would integrate the LDC's portfolio into theirs to achieve "economic efficiencies that will yield lower prices for all customers." *Id.* at 53. In return for the use of the assets in their own portfolios, the winning bidder would be obligated to provide sufficient gas to the LDC to serve the LDC's default service customers. The Department in its order preferred floating or indexed gas prices, rather than fixed, because while fixed prices protected customers from increases, they also prevented customers from benefitting from price decreases. *Id.* at 56.

LDCs' obligation to acquire capacity should be modified. *Id.* at 57.

## Comments

The restructured Massachusetts natural gas industry has not delivered what was promised–a natural gas market in Massachusetts that delivers "enhanced benefits to the consumers in the form of broader choice, increased efficiency, and lower cost." *Assignment of Interstate Pipeline Capacity*, D.T.E. 04-1, at 5. The Department, in opening the third year evaluation, focuses narrowly on "changes in upstream capacity market since the issuance of D.T.E. 98-32-B..." that may lead the Department "...to modify the existing mandatory method for upstream capacity assignment." *Id.* at 3-4. The Department should now review the competitive market, not only as it exists upstream, but also as it has developed here in Massachusetts. Now is the time to assess the situation and institute changes that will lead to the vision of the competitive market in Massachusetts described by the Department in 98-32-B, while adhering to the principles also annunciated in that order–"We will not attempt to create a competitive market, if the competitive market cannot develop and exist on its own or would artificially benefit only a narrow group of actors at the expense of others." *Id.* at 25.

The Department should expand the scope of its three year review of the competitiveness of the natural gas markets and address two categories of issues on a statewide basis within the context of a developing competitive market:

Planning and Procurement
Mitigating Price Volatility

### Planning and Procurement Issues

Planning and Procurement issues relate to the LDCs' obligation to serve. The Department has required LDCs to continue to plan for and contract for resources with the obligation to serve at least cost. LDCs may not have sufficient resources to serve the growing customer load within their service territory and may not have considered the return of all competitively served customers in developing capacity and supply plans. Recently, Bay State Gas Company petitioned the Department for permission to include a 10% contingency reserve in order to serve a portion of its migrated load if those customers return to utility service. Bay State Gas Company DTE 02-75. In its recent order, the Department denied Bay State's request and affirmed its policy that "LDCs are not required to serve customers if the addition of these new customers to the system would increase average costs." DTE 02-75 Order at 32, citing Boston Gas Company D.P.U. 88-67, at 282-283 (1989). The Department advised the Attorney General to raise related issues in this generic investigation. If the Department lifts the mandatory capacity assignment requirement without also modifying its current policies regarding LDCs' obligation to serve, customers may be unwilling to migrate. Other LDCs now may face the same problem alleged by Bay State. All of the LDCs should provide data regarding their ability to serve returning load, how they would arrange to serve customers if the Department required that service, and how the LDCs would recover the costs of serving this load from customers. The Department should allow for additional discovery, require LDC's to file testimony on the best way to accommodate returning load without shifting costs to other customers, and hold hearings with all interested parties. This process and added scope should assist the Department in deciding whether or not to continue mandatory capacity assignment.

Another important planning issue is mitigation of price volatility. The Department discouraged LDCs from entering into fixed price or long term contracts, those extending beyond the end of the transition period. DTE 98-32-B. The credibility of gas price indices has been undermined since 1999, in the wake of scandals and Federal investigations into gas price reporting inaccuracies and manipulation. FERC has yet to rule on whether it will require the establishment of an independent clearing house and, if so, how its operations will be structured. Given such circumstances and the extremely volatile prices customers have experienced recently, the Department should move away from total reliance on spot or indexed pricing. The Department should order the LDCs to provide data and assessments of cost savings, if any, that customers would have enjoyed during the past five years if the LDC had purchased 50 percent of their annual natural gas supplies on a fixed-price basis. Each LDC in response should describe what it believes would be the best fixed-price strategy (term of fixed-price contracts, the optimal volume for each contract and the delivery points and any other information that would be helpful in assessing whether to allow fixed-price contracting).

The Department should review the value of capacity auctions. LDCs have restructured their portfolios, which now may have significantly reduced levels of capacity in excess of peak demand and thus less value to wholesale marketers. There is now a history of portfolio auctions and some variety of arrangements (capacity management and portfolio optimization with benefit sharing). The Department should encourage LDCs to discuss their experiences and evaluate the role capacity managers can play going forward under two scenarios–one where 80% of the LDC's large customer load has migrated and the other where the LDC provides gas to all customers within its service territory. The size of the pool of portfolio bidders also may have changed; many large wholesale marketing companies may have left the market because of the wholesale market disruption. The Department should encourage LDCs to provide their insight into how the market changes have affected the availability and creditworthiness of capacity managers.

The Department should examine whether mandatory capacity assignments should continue, not only in the context of developing upstream competition but also in the context of the local and regional markets. The Department should obtain data not only on the development of competition locally, but also on number of marketers, customers and volumes based on the LDCs' customer classes, the amount (volume and cost per typical customer) of capacity, by type, that would have been available for assignment by class for each year 1996-2003, and the amount of capacity, by type, held by each LDC in excess of peak demand for each year 1996-2003. The Department should again consider current market conditions in the Northeast. We are still at the end of the pipeline. Production companies have recently cut drastically their proven reserve levels. Canadian gas production is being reduced. Recently, FERC authorized the Portland Natural Gas Transmission Service to reverse the direction of the flow on its pipeline so that it can export gas to Canada. Forty percent of the electric generation in New England is gas-fired.

Both FERC and ISO-NE have issued reports and studies indicating that the region is heavily reliant on natural gas and deliverability is an issue.

**Mitigating Price Volatility Issues**

Residential and small commercial and industrial customers (Small Customers) provide the bulk of LDCs' revenues. These customers recently have experienced price increases and disruptions from the implementation of load factor based Cost of Gas Adjustments (CGAs) and the highly volatile gas prices of the past four years.[3] According to a recent JD Powers and Associates study (October 2003), the most satisfied residential customers are those that believe their bills will not fluctuate very much month to month. Small Customers are "captive;" they do not have choices for gas supply, and they bear the unmitigated/unassigned capacity costs left by migrating customers.

The Department should work to bring choice in natural gas supply to Small Customers. KeySpan's affiliate in New Hampshire, EnergyNorth, offers its customers an optional fixed rate CGA. The Department has details on this program; it should take administrative notice of the related evidence and testimony provided in *KeySpan*, DTE 03-40. Tr. at 3241-3246. The Department should permit discovery and cross examination of witnesses regarding possible LDC implementation of similar programs in Massachusetts.

The Department has instituted a price volatility mitigation measure in KeySpan's dollar cost averaging program. *KeySpan Gas Purchasing Practices*, DTE 03-85 (2003). Although several LDCs wrote in support of that proposal, none has proposed a similar program. The Department should ask the LDCs to explain why they have not proposed similar programs and ask Boston Gas to provide data comparing its actual CGA rates to what rates would have been if KeySpan's purchasing program been effect during the winters of 2000/01, 2001/02, and 2002/03.

Conclusion

The Department should issue an order expanding the scope of its investigation to include (1) how LDCs plan and procure supplies and capacity, and (2) how to bring choice to customers who have none.

Sincerely,

Edward G. Bohlen

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[3] The Department currently requires LDCs to file interim CGA factors whenever they will either under or over collect gas costs by 5 percent. In the 2002/03 heating season, CGA rates changed three to four times during the six month heating season.

Assistant Attorney General